

No. 13,676

IN THE

United States Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

BEAR FILM Co., a corporation,
Respondent.

On Review of The Tax Court of the United States.

BRIEF FOR THE RESPONDENT.

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STATEMENT AS TO JURISDICTION.

This case was instituted by a petition filed in The Tax Court of the United States within ninety days of the date on which the deficiency letter was mailed to the respondent (R. 163, 165-182). Decision of the Tax Court was entered on July 24, 1952, finding a deficiency in income tax for the year 1945 in the amount of \$622.09 (R. 164, 199-200). On October 14, 1952, the Commissioner of Internal Revenue filed a petition for review by this Court and served notice thereof on the respondent (R. 164, 200-204). The jurisdiction of this Court is founded on Sections 1141 and 1142 of the Internal Revenue Code.

STATEMENT OF THE CASE.

The facts have been stipulated (R. 17-114, 183-185) and as stipulated and found by the Tax Court (R. 187-194) may be summarized as follows:

Respondent is a California corporation, having its principal office and place of business in San Francisco, California (R. 165, 182, 187). It is on the accrual and calendar year basis (R. 183, 187).

Prior to 1929, respondent's president and sole shareholder, Oscar Hansen, had placed his stock in trust with his mother, Josephine Hansen (R. 26-40, 98-102, 188). In 1929, Oscar Hansen died intestate, leaving his daughter, Virginia Hansen (referred to hereinafter by her married name, Virginia Hansen Vincent), as his sole heir. Josephine Hansen was appointed co-administrator of his estate. (R. 19-20, 52, 188.)

Immediately on her son's death, Josephine Hansen assumed control and asserted full ownership of the stock of respondent that had been transferred to her in trust, in violation of her duty as a trustee of the stock and as administratrix of her son's estate (R. 47-48, 52-53, 99-102, 188). Later in 1929, she persuaded her son, Albert Hansen, to give up his career as a member of the faculty of Purdue University to come to San Francisco to take over management of the company. Albert Hansen was elected president of respondent and became a director, filling the position vacated on the death of Oscar Hansen, his brother. (R. 48-49, 188-189.) During this period, respondent more than doubled its worth through Albert Hansen's efforts in building up and increasing its business (R. 92-93, 191). From 1929 until his death in 1940, Albert Hansen managed

the business of respondent and was paid a salary by respondent for his services during this period of \$81,210.09 (R. 49, 107, 189).

In 1929 Josephine also assigned all of the stock of respondent to Albert Hansen, who in 1939 transferred some of the stock to respondent in trust for his son, Robert Carmody Hansen. The remainder of the stock stood in Albert Hansen's name, or, after his death, in the name of his estate. (R. 28-29, 35-36, 189.) During this period, 1929-1941, respondent declared dividends on its stock in the amount of \$95,000, and paid to Albert Hansen or his estate as such dividends the sum of \$61,000. These payments were actually made in various amounts between December 31, 1937 and August 13, 1941. (R. 189.)

In 1940, after Albert Hansen's death, Virginia Hansen Vincent learned that she was the rightful owner of all of respondent's stock and commenced suit in the California Superior Court against respondent, Albert's estate and others for its recovery and for related relief. Judgment was entered for her on July 2, 1943, and was affirmed by the Supreme Court of California on May 7, 1946, in *Hansen v. Bear Film Co.*, 28 Cal. 2d 154, 168 P. 2d 946. (R. 14, 61-62, 189-190.)

The judgment awarded Virginia Hansen Vincent all of the stock of respondent and, insofar as it ran against respondent, provided as follows: (a) respondent was ordered to pay certain sums of money to her, including \$61,000 principal, representing dividends declared and paid on the stock after April 26, 1929, together with interest of \$17,676.09; and (b) respondent was ordered to turn over

to her that part of the stock held by it as trustee for Robert Carmody Hansen. Other material parts of the judgment provided that all unpaid dividends previously declared by respondent should be cancelled and that respondent should not demand or recover the \$61,000 previously paid to Albert Hansen or his estate as dividends. (R. 111-114, 190-191.) In 1946, respondent paid the judgment against itself to Virginia Hansen Vincent (R. 184, 192).

In reaching its judgment, the Superior Court found that Virginia Hansen Vincent was the owner of the stock of respondent and that Albert Hansen and his estate had no right thereto (R. 49-51, 190-191). The Superior Court also found that Albert Hansen had been the president and a director of the respondent at all times from May 24, 1929 until his death; that from March 12, 1930 to his death, Albert had controlled the entire board of directors; that all of the actions of the board of directors and all of the policies of respondent during this period had been dictated and determined by him alone; that he had given up an honorable and remunerative career in the field of teaching and scientific writing as a member of the faculty of Purdue University in order to take these positions with respondent; and that his efforts, diligence, skill, thrift, enterprise and ability had built up and had increased the business of respondent and had more than doubled its value and its worth. (R. 51-52, 77, 90, 92-93, 191.) As a result, the Superior Court found that the reasonable value of Albert's services to respondent during this period was not less than the sum of the compensation paid to him by respondent.

ent, \$81,210.09, and the amount previously paid to him and his estate as dividends, \$61,000 (R. 107-108, 191).

Respondent, in determining the amount of its net operating loss for 1946, deducted the sum of \$61,000 lost by it under the above judgment. This net operating loss was carried back under Section 122 of the Internal Revenue Code to offset income realized in 1945. However, the Commissioner reduced the amount of the 1946 loss available as a carryback by disallowing the deduction in 1946 of the \$61,000. Accordingly, the Commissioner determined a 1945 deficiency against respondent of \$25,376.20. (R. 169-181, 186.)

On petition for review of the deficiency determination, the Tax Court overruled the Commissioner on this point to hold that the sum of \$61,000 was properly deducted by respondent in 1946 as additional compensation paid to Albert Hansen under Section 23(a)(1)(A) of the Internal Revenue Code. Consequently, the Tax Court reduced the amount of the deficiency for 1945 to \$622.09.¹ (R. 187-192, 194-196, 199-200.)

The Commissioner sought review of the decision of the Tax Court, but in his opening brief he has conceded that "the decision herein is correct" and that his review is filed merely "for protective purposes in the event that this Court should reject the theory on which the Tax Court decided the issue presented in the case of *Vincent v. Commissioner* * * *" (R. 200-202, Op. Br. 9).

¹The latter amount involves issues which are not here on review.

SUMMARY OF ARGUMENT.

As found by the Tax Court below, the payment of \$61,000 by respondent in 1946 represented additional compensation paid by respondent to Albert Hansen, its former president, for services previously rendered by him. Although the payment itself was made to Virginia Hansen Vincent, it was by way of compound novation, discharging Albert Hansen's obligation to pay Virginia Hansen Vincent \$61,000 as accumulated dividends in return for a release of respondent's liability to pay \$61,000 to the estate of Albert Hansen. Alternatively, respondent lost in 1946 a cause of action formerly held by it to recover \$61,000 in accumulated dividends previously paid to Albert Hansen and his estate. The only consideration for the cancellation by the judgment of this cause of action was the simultaneous cancellation of Albert Hansen's right to recover \$61,000 as additional compensation from respondent. In either event, the payment or the cancellation of indebtedness represented a deductible amount as a business expense under Section 23(a)(1)(A) of the Internal Revenue Code.

The deduction, being contested until judgment became final in 1946 and payment being made in that year, was properly taken in 1946 under Section 43 of the Internal Revenue Code. Accordingly, the Tax Court was correct in allowing respondent to deduct the sum of \$61,000 in 1946 and its decision should be affirmed.

ARGUMENT.**I. UNDER THE PROVISIONS OF INTERNAL REVENUE CODE SEC. 23(a)(1)(A), WHICH AUTHORIZES DEDUCTIONS FOR COMPENSATION PAID FOR SERVICES, RESPONDENT PROPERLY DEDUCTED THE SUM OF \$61,000 PAID UNDER THE JUDGMENT.**

Under Section 23(a)(1)(A) of the Internal Revenue Code, respondent was entitled to deduct in the year 1946 "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *."² The record shows that respondent paid the amount of \$61,000 in 1946 and that Albert Hansen had rendered personal services to the respondent of a value greater than the salary previously received by him. This discrepancy between the compensation previously paid and the value of his services was equal to at least \$61,000 (R. 184, 191-192). The payment in 1946 by respondent was not made directly to the estate of Albert Hansen, but was made to Virginia Hansen Vincent in satisfaction of her judgment. However, the Tax Court found that the payment was in fact a payment for the benefit of the estate of Albert Hansen in consideration of his past services (R. 191-192). This finding was reached by the court after a careful scrutiny of the findings and decision of the Superior Court of California. That scrutiny revealed the presence of two obligations both for the same amount, \$61,000:

²As amended by §121(a), Revenue Act of 1942, c. 619, 56 Stat. 798; for a more complete text, see Op. Br. 2.

(1) The obligation of the estate of Albert Hansen to pay Virginia Hansen Vincent the amount of dividends wrongfully received by it and by Albert Hansen on the embezzled stock;

(2) The obligation of respondent to pay the estate of Albert Hansen the same sum as additional compensation for services rendered by him.

Since the two obligations were for the same amount, the Tax Court held that the payment by respondent of \$61,000 to Virginia Hansen Vincent effected a compound novation discharging both obligations. The payment by respondent was, therefore, the equivalent of a payment to the estate of Albert Hansen for Albert's prior services and a payment by the estate to Virginia of the dividends. (R. 195-196.)

Consequently, the Tax Court properly found that, as far as respondent is concerned, the payment was compensation for services rendered, deductible in 1946 as a business expense under Section 23(a)(1)(A).

The finding and decision of the Tax Court on this point are supported by law and by the evidence before the court. The fact that respondent first incurred the obligation to pay for Albert's services in a taxable year after the services were performed is immaterial; that fact does not bar the deduction for compensation in the year paid. *Lucas v. Ox Fibre Brush Co.*, (1930) 281 U.S. 115.

Nor does the fact that the payment to the estate of Albert Hansen was by way of discharging its obligation to Virginia Hansen Vincent affect the validity of this

deduction. Compensation may be paid in many forms. Payment of an employee's tax liability may be deductible compensation. *Old Colony Trust Co. v. Commissioner*, (1929) 279 U.S. 716. A profit to an employee traceable to an option granted by the employer may be compensation. *Commissioner v. Smith*, (1945) 324 U.S. 177. An annuity contract purchased by the employer for the employee may be compensation. *Crispin v. United States*, (CA 9, 1952) 200 F. 2d 99. The cancellation of an employee's indebtedness may be compensation. Reg. 111, Sec. 29.22(a)-13; *Taylor-Logan Co. v. White*, (CA 1, 1933) 65 F. 2d 994.

Alternatively, the deduction for compensation may be justified by reference to a third obligation which appears in the judgment of the Superior Court. That judgment, *inter alia*, provided that the obligation of Albert Hansen and his estate *to return to respondent* the \$61,000 previously paid by it as dividends be cancelled (R. 113, 195). If any consideration was received by respondent for this cancellation of a debt owing to it, that consideration could only be the equivalent cancellation of respondent's obligation to the estate of Albert Hansen to pay \$61,000 for his prior services. As pointed out *supra*, compensation may be paid in many forms; the cancellation of an employee's debt to the employer under circumstances similar to these was held to be deductible as compensation. *Taylor-Logan Co. v. White*, *supra*; Reg. 111, Sec. 29.22(a)-13, *supra*.

It is submitted, therefore, that the \$61,000 payment or loss by respondent in 1946 was properly held by the Tax

Court to be deductible as compensation for services rendered.

II. THE DEDUCTION FOR COMPENSATION WAS PROPERLY ACCRUED AND TAKEN BY RESPONDENT IN 1946.

Under Section 43, Internal Revenue Code,³ the respondent, being on the accrual basis, was entitled to take its deductions for compensation paid in the year when "paid or accrued." Prior to 1946, respondent had contested its liability to pay the sum of \$61,000 and had refused to pay that amount until the decision of the Supreme Court of California on appeal was entered on May 7, 1946. Thereafter, during the same taxable year of 1946, respondent paid the sum as required by the judgment. The deduction, therefore, was properly taken in 1946. *Dixie Pine Products Co. v. Commissioner*, (1944) 320 U.S. 516; *Security Flour Mills Co. v. Commissioner*, (1944) 321 U.S. 596.

Therefore, it is submitted, the Tax Court was correct in permitting the contested payment to be deducted in 1946, when respondent's liability therefor became final and the amount was paid.

CONCLUSION.

It is therefore submitted that the judgment should be affirmed. The Commissioner of Internal Revenue does not argue to the contrary. In his conclusion, the Commissioner states:

³For text, see Op. Br. 3.

“The decision of the Tax Court herein is correct and, except for the eventuality above mentioned, should be affirmed.” (Op. Br. 12.)

The “eventuality above mentioned” is the fear of the Commissioner that this Court will reject one of the theories upon which the Tax Court predicated its decision in *Vincent v. Commissioner*, now pending on review before this Court (Docket No. 13649).

That this concern of the Commissioner is entirely groundless is readily apparent from a perusal of the issues and record of the *Vincent* case, *supra*.⁴ That case has been presented to this Court by Virginia Hansen Vincent, as petitioner, seeking a reversal of the Tax Court’s decision entering a deficiency of 1946 income taxes against her of \$52,088.81 (Vincent R. 154). Petitioner therein advances three separate grounds for reversal, any one of which is sufficient to invalidate the decision below. Moreover, *none* of the arguments advanced on behalf of petitioner in the *Vincent* case is inconsistent in any respect with the decision of the Tax Court herein. No argument made therein denies that the payment of \$61,000 to Vir-

⁴We regret the necessity of complicating this case by describing and developing the issues presented in the *Vincent* case, *supra*, but we believe it is necessary in order to answer an implication of the Commissioner that a reversal of the *Vincent* case in favor of the taxpayer will necessitate a reversal of the present case in favor of the Commissioner (see Op. Br. 12). The positions of the two separate taxpayers in the two cases are not inconsistent, and a victory for one should have no effect on the merits of the questions raised by the other. This is a conclusion that we believe must spelled out in detail herein, at the risk of unduly complicating and lengthening this brief, in order to prevent the erroneous opinion of the Commissioner to the contrary from prejudicing the meritorious case of either of the taxpayers.

ginia Hansen Vincent represents "accumulated dividends," as found by the Tax Court herein. This is the point upon which the Commissioner apparently fears an inconsistency (see Op. Br. 10-11), but his fears are without foundation in fact.

Neither the first nor second ground for reversal in the *Vincent* case involves the status or classification of the \$61,000 payment made by respondent to Virginia Hansen Vincent. Both the first and second grounds for reversal in the *Vincent* case involve Mrs. Vincent's right to deduct the entire amount she spent in recovering her judgment, and no question concerning the \$61,000 payment is raised in them. (See *Vincent*, Pet. Op. Br. 10-48.)

The third independent ground justifying reversal of the *Vincent* case is entitled, "The payment of \$61,000 received by petitioner under the judgment was not taxable income to her in 1946." The argument thereunder (see *Vincent*, Pet. Op. Br. 48-53) accepts the fact found by the Tax Court that the payment of \$61,000 to Virginia Hansen Vincent in 1946 represented "accumulated dividends." (*Id.* at 48-49.) The argument is made, not on the ground that the payment was something else than accumulated dividends, but on the basis that the accumulation did not constitute taxable income to Virginia in 1946.

Therefore, no inconsistency exists between the positions urged by the taxpayers in the two cases. Since the "eventuality" envisioned by the Commissioner in his Opening Brief herein has not come to pass, we believe that it is incumbent upon him to dismiss his appeal in the present case, for he advances no meritorious contention of law or

fact for this Court to examine and to rule upon. Neither the interests of justice nor of judicial administration will be served by further prolonging the "protective appeal" taken by the Commissioner in this proceeding.

Whether or not the Commissioner decides to dismiss his appeal, it is clear the decision of the Tax Court is correct and should be affirmed.

Dated, San Francisco, California,

July 6, 1953.

Respectfully submitted,

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